In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 1471

C. A. SAMMONS, Individually and as Independent Executor of the Estate of ROSINE S. SAMMONS, Deceased, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The district court filed no opinion, basing its judgment (Pet. App. B 1-B 2) upon the jury's answers to special interrogatories. The opinion of the court of appeals (Pet. App. A 1-10) is reported at 433 F. 2d 728.

JURISDICTION

The judgment of the court of appeals was entered on November 4, 1970 (Pet. App. B 3-B 4). A petition for rehearing was denied on December 15, 1970 (Pet. App. B 6). The petition for a writ of certiorari was filed on

March 15, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, on the record, both courts below correctly held that petitioner constructively received a dividend where, as the jury found, assets were transferred from one to another of the corporations controlled by petitioner for $500,000 less than fair market value.

STATUTES INVOLVED

The statutory provisions involved are set forth in the Appendix, *infra*, pp. 9-10.

STATEMENT

Shortly before January, 1958, five corporations which petitioner controlled directly or indirectly,[1] and which, in turn, owned all of the stock of Fulton Bag and Products Company ("Texas Fulton"), contributed $700,000 to the capital of Texas Fulton. It is undisputed that $700,000 was the cost basis of the five corporations in Texas Fulton's stock, Texas Fulton having previously been a dormant corporation. On January 2 and 3, 1958, Texas Fulton and American Republic Life Insurance Company ("American Republic"), one of the five corporations that owned the Texas Fulton stock, acquired a multi-wall paper bag business, American

[1] Petitioner directly controlled certain of the corporations involved through stock ownership in those corporations. He indirectly controlled other of the corporations involved through ownership of the controlling stock of their parent corporations.

Republic acquiring the fixed assets of that business, and Texas Fulton the remaining assets. Texas Fulton immediately leased the fixed assets from American Republic and commenced its multi-wall bag operations. (Pet. App. A 2; R. 41-42, 252, 265-266, 289.)[2]

At the beginning of February, 1958, the West Virginia Pulp and Paper Company ("Westvaco") began negotiations with petitioner, initially through officers of Texas Fulton, with a view to purchasing the multi-wall bag business (R. 225, 231, 235). On February 7, petitioner advised Westvaco that his price was his original cost plus $500,000 plus expenses of sale (R. 205-206, 209, 222-223). Further negotiations between the parties took place on February 9, 11, 14 and 18, with Westvaco indicating on February 18 that it was willing to close along the lines of petitioner's initial asking price (R. 205, 209, 211, 215-219, 231-232).

Meanwhile, on some date between February 10 and February 19, the five corporations owning the Texas Fulton stock sold it at cost ($700,000) to Fidelity National Life Insurance Company ("Fidelity National"), another corporation controlled by petitioner. On February 19, Fidelity National borrowed the purchase money from a bank pursuant to a loan application of the same date. (Pet. App. A 2; R. 265-266, 278-279, 313-315, 329.)

On March 8, 1958, Westvaco contracted to purchase the Texas Fulton stock from Fidelity National for the latter's cost of the stock ($700,000) plus $500,000 with

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[2] "R." references are to the record appendix in the court of appeals which we have lodged with the Clerk of this Court.

certain minor adjustments. American Republic thereupon transferred the fixed assets to Texas Fulton for its cost, and the Texas Fulton stock was then transferred to Westvaco on April 2, 1958, under the terms of the March 8 contract. (Pet. App. A 3; R. 49, 51, 338.)

At the conclusion of the trial below, in answer to special interrogatories, the jury returned a verdict that the stock of Texas Fulton and the fixed assets of American Republic were transferred to Fidelity National for $500,000 less than the fair market value thereof (Pet. App. B 1). As appears from the court's charge to the jury (R. 400-405), the judgment on the verdict (Pet. App. A 2) reflected treatment of the $500,000 spread as a constructive dividend to petitioner, since the transfers were made at his behest and for his benefit by giving Fidelity National, his corporation, an asset—the Texas Fulton stock—worth $500,000 more than Fidelity National paid for it.

ARGUMENT

The decision below is correct. There is no conflict or other basis for further review.

1. Sections 301(c)(1) and 316(a) of the Internal Revenue Code (Appendix, *infra*, pp. 9-10), provide that a distribution to a stockholder out of a corporation's earnings and profits constitutes a dividend, and that such a distribution is includable in the stockholder's gross income. But it has long been settled that there may be a constructive dividend to a stockholder even though there is no formal declaration and distribution of a dividend. The test is whether there is a diminution

in the earnings and profits of a corporation which inures to the benefit of a stockholder, in one form or another. Familiar examples of constructive dividend situations are cases in which there is a transfer of corporate assets to a stockholder for a price which is less than the property's fair market value (*Waldheim* v. *Commissioner,* 244 F. 2d 1 (C.A. 7)), or in which a corporation pays a stockholder's debt to a third party (*Sachs* v. *Commissioner,* 277 F. 2d 879 (C.A. 8), certiorari denied, 364 U.S. 833; *Wall* v. *United States,* 164 F. 2d 462 (C.A. 4)).

By the same token, the courts have held that a stockholder who causes a transfer of assets from one to another of the corporations he controls, for an inadequate consideration, receives dividend income to the extent that the transferor's earnings and profits are diminished. See, *e.g., Biltmore Homes, Inc.* v. *Commissioner,* 288 F. 2d 336 (C.A. 4), certiorari denied, 368 U.S. 825; *Worcester* v. *Commissioner,* 370 F. 2d 713 (C.A. 1); *Lonsdale* v. *Commissioner,* 32 F. 2d 537 (C.A. 8), certiorari denied *sub nom. Lonsdale* v. *Lucas,* 280 U.S. 575. In these situations, the stockholder is economically benefited by the enrichment of his second corporation, just as he is by the payment of a debt which he owes to a third party. Moreover, taxing the diverted earnings to him is consistent with the "assignment of income" cases, in which corporate earnings diverted by a stockholder to a third party are taxable to him even though he receives no direct economic benefit, because he has exercised the power to dispose of the income. See *Helvering* v. *Horst,* 311 U.S. 112.

Here, petitioner caused five of his corporations to sell assets at cost to Fidelity National, another of his corporations, at the very time he was successfully negotiating a sale of those assets to Westvaco for cost plus $500,000. Within weeks after the transfer to Fidelity National, the sale to Westvaco at cost plus $500,000 was consummated. Under these circumstances, the jury was surely warranted in finding that Fidelity National acquired the assets at $500,000 less than fair market value, and the courts below quite properly ruled that the $500,000 diverted from the earnings and profits of the five transferor corporations constituted a constructive dividend to petitioner. Compare *Commissioner* v. *Court Holding Company,* 324 U.S. 331.

2. Petitioner erroneously asserts conflict with *Palmer* v. *Commissioner,* 302 U.S. 63 (Pet. 5-8). In *Palmer* this Court held that there was adequate consideration for a distribution of rights to shareholders and, consequently, that there was no constructive dividend. *Palmer* has no application where, as here, the consideration for a transfer of corporate assets is less than the relevant fair market value. The Court went on to say by way of dictum in *Palmer* (302 U.S. at 70) that a distribution of corporate assets to stockholders could only give rise to a dividend if there was "some showing that the transaction is in purpose *or effect* used as an implement for the distribution of corporate earnings to stockholders." (Emphasis supplied.)

The quoted dictum cannot be read to mean that a diversion of corporate assets does not constitute a dividend unless the stockholder who diverts the assets

intends a taxable dividend. Properly interpreted, the Court's reference to "purpose or effect" is to the consequences of a taxpayer's actions and not his motives.[3] This is made clear by the Court's denials of petitions for certiorari in several cases, cited above, that are squarely in accord with the decision below, and by the Court's recent decision in *Commissioner* v. *Gordon,* 391 U.S. 83. The Court there concluded, without mentioning purpose or intention, that (pp. 89-90)—

> it is clear that when a corporation sells corporate property to stockholders *or their assignees* at less than its fair market value, thus diminishing the net worth of the corporation, it is engaging in a "distribution of property" as that term is used in § 316. Such a sale thus results in a dividend to shareholders unless some specific exception or qualification [enumerated in the statute] applies. * * * [Emphasis supplied.]

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[3] Petitioner's argument (Pet. 6-7) that he did not intend to divert corporate earnings for his own benefit must, in any event, fail. The claim that the five transferor corporations intended to hold the stock merely as agent for Fidelity National was not properly raised in the trial court, and the court of appeals found no justification in the record for passing on it (Pet. App. A 9-10). The further claim was that the transactions in question were intended to benefit the transferor corporations. But petitioner failed to convince either of the lower courts that there was an adequate justification or countervailing benefit, from the standpoint of the transferor corporations, for relinquishing the $500,000 profit available from Westvaco and channeled to Fidelity National.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APRIL 1971.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) *In General.*—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * *

(c) *Amount Taxable.*—In the case of a distribution to which subsection (a) applies—

(1) *Amount constituting dividend.*—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

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SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the

earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

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